Nos. 12535 and 12536

United States
Court of Appeals
For the Ninth Circuit

LOUIS RUBINO,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent,

and

CATHERINE RUBINO,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent,

Brief for Petitioners

On Petitioner to Review Decisions of the Tax Court of the United States

WAREHAM C. SEAMAN

CONTENTS

CITATIONS

CITATIONS

Nos. 12535 and 12536

United States
Court of Appeals
For the Ninth Circuit

LOUIS RUBINO,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent,

and

CATHERINE RUBINO,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent,

Brief for Petitioners

On Petitioner to Review Decisions of the Tax Court of the United States

STATEMENT OF THE CASE

These are petitions to review determinations of The Tax Court of the United States (R. 42, 43) that there are deficiencies in the income and victory tax of the petitioners for the year 1943 in the amounts of $1,655.27 and $1,687.29

respectively, under the provisions of sections 1141, 1142, and 1143 of the Internal Revenue Code (Pt. 1, 53 U. S. Stat. at L.; Title 26, United States Code), as amended by section 36, Act of June 25, 1948 (62 U. S. Stat. at L. 991; Suppl. II, United States Code, 1946 Ed, p. 684). The opinion of The Tax Court (R. 26) is reported at 8 TCM 1096.

The asserted deficiencies are based upon the respondent's refusal to permit certain gains on the sales of certain dwelling units (houses and lots) constructed for renting and rented by the petitioners under the rules of the office of Production Management and of the National Housing Agency to eligible war workers, to be taxed as capital gains according to section 117(j), Internal Revenue Code.

The respondent based his treatment of the gains in question as ordinary income rather than capital gain (taxable at a lower rate and not subject to the victory tax) on his finding that the properties in question were held for sales to customers in the ordinary course of the petitioners' business (R. 19); and the finding was confirmed by The Tax Court in its findings of fact (R. 32). The validity of that finding on the basis of the stipulation of facts (R. 74-76) is the issue in these petitions for review.

FACTS INVOLVED

The essential facts on this issue were stipulated (R. 74-76), and additional evidence thereon was presented at the hearing before Judge Samuel B. Hill (R. 44-73). In summary these facts are as follows:

The petitioners are husband and wife all of whose income was community property income (Par. 2, Stipulation of Facts, R. 74), and their taxable income was returned in moieties on their separate returns (R. 54). The petitioner husband had started in the millwork and lumber business at Stockton, California, in 1930 (R. 46) after considerable prior experience in that line of work. In 1940 he branched out into the building contracting business and developed a city subdivision (R. 46), and in 1942 he started building houses for rent in two projects involving 63 family units (Exhibits 1 and 2; R. 49-50), which were rented to qualified war workers through the petitioners' rental agents, the firm of Sims & Grupe (R. 51). In connection with his contracting business Mr. Rubino had built probably six or seven (R. 47, 57) dwellings for sale before starting on the rent housing projects in 1942. From 1935 or 1936 on the petitioners were in the business of farming near Linden, California, (R. 45, 46, 67, Exhibits A and B); and subsequent to 1943 they were also engaged in the restaurant business and in the wholesale

building material and hardware business (R. 53).

Thirty-three rented dwelling units were sold by the petitioners during the taxable year 1943, within the terms of the wartime regulations under which they were built and operated as rent properties. The gains on the sales of 23 such units, which had been held for less than six months were returned as ordinary income subject to the victory tax in the petitioner's returns. The other ten units sold had been held for more than six months from the dates of completion of the dwellings. Because of such term of holding the gains on the sales of these units were returned as if they were gains on the sales of capital assets according to the provisions of section 117(j), Internal Revenue Code (copied *infra*), with a result of lower income taxes on the petitioners' returns and the exclusion of the gains from the amount subject to the victory tax temporarily in effect for that year (Stipulation of facts, par. 5, R. 75; Exhibit B). The right of the petitioners so to classify the gains was denied by the respondent. The Tax Court's affirmance of such denial is the sole issue in this petition for review.

In the petitioners' 1943 returns there was deducted from their gross income from rents and allowed by the respondent depreciation in the sum of $2,141.15 on thirty of the above-

mentioned rent dwellings which had been rented during that year and which were being rented at the end of the year. No depreciation was, however, deducted for the ten dwellings which were part of the units sold during 1943, the gains from which sales are the subject of controversy herein, but depreciation of these ten dwellings was admitted by the respondent to be allowable at the same rate for 1942 and 1943 as allowed for the 30 dwellings in use at the end of 1943 in the stipulation of facts filed in The Tax Court (Par. 4 of stipulation, R. 75) which stipulation was adopted in the findings of fact in the report of The Tax Court (R. 28, 30).

STATUTES INVOLVED

The parts of the income tax law (sections 23(1), 117(a), and 117(j), Internal Revenue Code (Title 26, United States Code) which are chiefly involved in this proceeding are copied hereunder for the convenience of the Court.

> SEC. 23. DEDUCTIONS FROM GROSS INCOME
>
> In computing net income there shall be allowed as deductions—
>
> (1) *Depreciation.* A reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) —
>
> (1) of property used in the trade or business, or
>
> (2) of property held for the production of income.

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) *DEFINITIONS—*
As used in this chapter —

(1) CAPITAL ASSETS — The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(1), or an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue, or real property used in the trade or business of the taxpayer;

* * * *

(4) LONG-TERM CAPITAL GAIN — The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing net income;

(j) GAINS AND LOSSES FROM INVOLUNTARY CONVERSION AND FROM THE SALE OR EXCHANGE OF CERTAIN PROPERTY USED IN THE TRADE OR BUSINESS —

(1) DEFINITION OF PROPERTY USED IN THE TRADE OR BUSINESS — For the purposes of this subsection, the term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (l), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Such term also includes timber with respect to which subsection (k) (1) or (2) is applicable.

(2) GENERAL RULE — If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or immi-

nence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. For the purposes of this paragraph:

> (A) In determining under this paragraph whether gains exceed losses, the gains and losses described therein shall be included only if and to the extent taken into account in computing net income, except that subsections (b) and (d) shall not apply.
>
> (B) Losses upon the destruction, in whole or in part, theft or seizure, or requisition or condemnation of property used in the trade or business or capital assets held for more than 6 months shall be considered losses from a compulsory or involuntary conversion.

POINTS ON WHICH THE PETITIONERS RELY

I. The addition of section 117(j) to the income tax law by the Revenue Act of 1942 was a relief measure to be construed liberally in favor of taxpayers.

II. The opinion below was inconsistent with The Tax Court's prior interpretation of section 117(j), Internal Revenue Code.

III. The Tax Court's finding of ultimate fact that ten rented dwelling units "were held by petitioner primarily for sale to customers in the ordinary course of his business" was contrary to the stipulation of facts and inconsistent with the facts in the record.

ARGUMENT

I. The addition of section 117(j) to the income tax law by the Revenue Act of 1942 was a relief measure to be construed liberally in favor of the taxpayers.

A lucid explanation of the legislative history and intent of section 117(j) as added to the income tax law by section 151 of the Revenue Act of 1942 (c. 619, 56 U. S. Stat. at L.) is found in the 1949 Supplement, Vol. 3, to Mertens' Law of Federal Income Taxation, Sec. 22.11(a), pp. 257 et seq. The Congressional Committee Reports cited in that explanation indicated very plainly that the intent of the sub-section was to furnish relief in the taxation of gains from certain types of transactions (including the sale of depreciable property and land used in a trade or business) without denying taxpayers the full benefit of the provisions of the prior law in the case of losses and in addition, to extend the benefit of any limited deductions to losses on the disposition by sale, exchange, or involuntary conversion of real estate used in the trade or business.

The United States Court of Appeals for the Eighth Circuit has recognized the special character of this part of the income tax law as a relief provision in *Albright v. United States,* 173 F. 2d 339 (1949), 37 A. F. T. R. 1125, a case involving farmer's sales at a gain of dairy and breeding livestock subject to an allowance for depreciation, where it said:

> "Section 117(j) was intended as a relief measure applicable alike to all taxpayers within its provisions. *Leland Hazard,* 7 T. C. 372. That it was so intended is clearly expressed in the report of the Committees of the House of Representatives and of the Senate in charge of the bill".

The Tax Court had given that section the same special character in its opinion in the *Hazard* case, *supra,* 1946, and in *William H. Jamison,* 8 T. C. 182 (1947), which cases, incidentally, both involve the sales by taxpayers of property used in the business of renting stores or dwellings.

II. The opinion below was inconsistent with The Tax Court's prior interpretation of section 117(j), Internal Revenue Code.

From its first case arising under the provisions of section 117(j), Internal Revenue Code, as added by the Revenue Act of 1942, *Leland Hazard,* 7 T. C. 372 (1946), down to *Nelson A. Farry,* 13 T. C. 8 (1949), The Tax Court had followed closely and impartially an interpretation of the terms of section

117(j) to include all sales of property which the owners had held for rent and which was, from that fact, subject to the allowance for depreciation granted by section 23(l) of the income tax law, regardless of the immediate circumstances of its sale. The provisions of section 117(j) are by no means limited to involuntary conversion transactions nor even to sales induced by force of economic circumstances such as pressure of creditors, adverse operating results, and the like. As is evident from the application given them by the Court of Appeals for the Eighth Circuit in the *Albright* case, *supra,* to sales of dairy and breeding animals by a farmer, they include normal and recurring transactions of a continuing business. And the Tax Court has been quick to follow that opinion. Cf. *Fawn Lake Ranch Co.,* 12 T. C. 1139 (1949), and *Isaac Emerson,* 12 T. C. 875 (1949). In so doing it is merely being consistent with its line of rent property cases, which includes, in addition to the *Hazard* and *Farry* cases, *supra,* the following:

William H. Jamison, 8 T. C. 173 (1947);

Solomon Wright, Jr., 9 T. C. 173 (1947);

Elgin Building Corp., 8 T. C. M. 114 (1949);

as well as a number of other memorandum opinions.

In all of its cases involving rent properties,

and, more recently, the cases involving livestock subject to the allowance for depreciation, the status of the property with respect to the depreciation allowance has been the touchstone of the classification of the sale as being within or without the definition of property covered by the provisions of section 117(j) as it had been previously with regard to the changed definition of capital assets in section 117(a)(1) of the Revenue Act of 1938 by which property used in business subject to the allowance for depreciation was excluded from that definition. If the property was, or had been, subject to the allowance for depreciation, it was *ipso facto* excluded from the application of the capital gain and loss provisions of the law. A basic opinion following the 1938 change is *John D. Fackler,* 45 B. T. A. 708 (1941), affirmed (C. C. A. 6 1943), 133 F 2d 509, 30 A. F. T. R. 932, which case and an extreme one, so far as its facts are concerned, *N. Stuart Campbell,* 5 T. C. 272 (1945), were the precedents for the leading case under the 1942 amendment adding section 117(j) to the law, *Leland Hazard, supra.*

It is significant for the petitioners' purposes that Judge Hill's opinion below (R. 34 *et seq.*) omits any mention of any of these cases by way of distinguishing them or avoiding their implications in the situation presented by the stipulated facts, citing instead a group

of cases which either arose for taxable years prior to 1939 or in which the facts are not comparable to those in this case.

III. The Tax Court's finding of ultimate fact that ten rented dwelling units "were held by petitioner primarily for sale to customers in the ordinary course of his business" was contrary to the stipulation of facts and inconsistent with the facts in the record.

The stipulation of the parties regarding the subject matter of this petition for review is found in paragraphs 4 and 5 of the stipulation of facts (R. 75), which The Tax Court found to be true (R. 28), and its report (R. 30, 31) copies or paraphrases the facts thus stipulated in the course of the Court's statement of the facts found on "Issue 1".

In the "Opinion" part of the report of the division of The Tax Court (R. 34-39) Judge Hill has explained his finding of ultimate fact complained of in this proceeding for review of that Court's decision as being made on the failure of the facts proven by the petitioners to overcome the presumption of the correctness of respondent's determination quoted in his findings of fact (R. 32) in the words as follows: "Since these transactions were frequent and continuous, it is considered that these houses are properly held for sale in the ordinary course of your business".

It is the petitioners' primary contention here that when the respondent stipulated as he did, in a concession right down to the exact amounts claimed in assignments of error 4(a) and 4(c) of the petitions (R. 5 and 6), that the depreciation claimed as "sustained, suffered and allowable on certain rent houses constructed * * and rented and used in the business of renting dwellings" was allowable in the amounts claimed, he had precluded any further contention on his part that the units in question were not held and used in the petitioners' business of renting dwellings. The only section of the income tax law under which an allowance for depreciation may be made is section 23(l), I. R. C., which by its terms requires that the depreciation allowable must be either "(1) of property used in the trade or business, or (2) of property held for the production of income." If, as the respondent contended in his briefs in the proceeding below and as Judge Hill found, the dwelling units in question had been "held by petitioner primarily for sale to customers in the ordinary course of his business", then the depreciation has been made directly contrary to the provisions of section 23(l). In his use of the word "primarily" in his finding Judge Hill indicates the possibility that he considers that the allowance of depreciation on houses the subject of sales may be squared with the

terms of section 23(l) by their being "secondarily" or in some degree less than "primarily" used in the business of renting dwellings, thus solving the apparent conflict between his finding and the allowance of depreciation. Such ambiguity of primary and secondary uses is apparently repugnant to the respondent's own regulations on the allowance of depreciation.

Reference to the respondent's regulations respecting depreciable property, Sec. 29.23 (l)-2, Regulations 111 (Part 29, Title 26, Code of Federal Regulations), makes this repugnance abundantly clear. That section reads in part as follows:

> The necessity for a depreciation allowance arises from the fact that certain property *used in the business,* or treated under section 29.23 (a)-15 as held by the taxpayer for the production of income, gradually approaches a point where its usefulness is exhausted. The allowance *should be confined to property of this nature.* * * * *It does not apply to inventories or to stock in trade,* or to land apart from the improvements or physical development added to it. * * * The deduction of an allowance for depreciation is limited to property *used in the taxpayer's trade or business,* or treated under section 29.23(a)-15 as held by the taxpayer for the production of income. * * *

In the respondent's Bulletin F (1942) it is stated (p. 89) that

> A dealer in automobiles may not deduct

> depreciation on either new or used automobiles which constitute part of his stock in trade, since such items are required to be inventoried under the provisions of section 22(c) of the Internal Revenue Code.

The last quoted statement appears to have been based on a venerable opinion of The Tax Court in *Munising Motor Co.*, 1 B. T. A. 286 (1925).

Judge Hill has pointedly avoided in his opinion any reference to the well established integration of the allowance of depreciation with the classification of property as excepted from the definition of capital assets in section 117(a) (1), Internal Revenue Code, and as included in assets subject to the provisions of section 117(j) as defined in section (117(j)(1), *idem.* See in this connection our discussion of this integration in the argument on Proposition II above. The suspected reason for such avoidance is that it would have interferred with his finding excuses rather than reasons for the determination of ultimate fact against the petitioners which he had arrived at on what appears to be an unreasoned basis derived possibly from his impression of the petitioner husband formed during the latter's testimony at the hearing or from some personal attitude toward the policy underlying the relief provisions of section 117(j).

The lameness of Judge Hill's excuses is il-

lustrated in his emphasis of the statement of Mr Rubino's accountant, Mr. Konig, attached as a rider to his 1942 return (Exhibit A), copied in the opinion (R. 35), as "proving" the taxpayers' intent to build and hold the houses in question "primarily for sale". To explain the bearing of such a gratuitous statement on the accountant's part on his conclusions he had to make two assumptions (R. 37) totally a variance with the petitioner's testimony regarding his returns (1) "that a person of petitioner's apparent business acumen would express his intention with respect to the homes in question to the accountant who made out his returns" and (2) that "certainly there must have been some discussion between him and his accountant concerning the status of these homes". The pertinent testimony of Mr. Rubino at the hearing with regard to the contents of his returns was

> "As far as these (his returns) are concerned I know very little of these here. I have my accountant to explain all of these here. All I do is sign one of them, they pick them up, prepare them for me, then send them in to you. You have our records, and that is all Greek to me." (R. 71), and
>
> "Through the tax situation I would say that my rentals would come out to the best advantage. That is, I am not saying that —like I say, my accountant takes care of all that. I am not too familiar with any of these statements. That is, I have them take care of them for me." (R. 65)

It is obvious that Mr. Rubino was not in practice or in temperament a man who bothered with the details of his financial statements or tax returns or discussed them with his accountants.

It would appear from Judge Hill's emphasis, on this matter from Mr. Rubino's 1942 return, that he had in mind some sort of a subjective test of the question as to whether the petitioners were in the business of renting dwellings, by which a statement of the accountant who prepared the return in explanation of the method of accounting for the costs of finished dwellings which was technically subscribed to by the petitioner husband when he signed his return, would negative the objective facts shown by the income tax returns, and by the stipulation of facts that the petitioners had rented during the years 1942 and 1943 no less than 64 dwellings. A diligent search of the cases disclosed nowhere the approval of a subjective test in a question of this kind.

In evaluating the petitioner's testimony at the hearing as "proof" of Mr. Rubino's not being in the business of renting dwellings Judge Hill picks out a general statement (R. 36) by the witness of his business activities at the very beginning of his testimony but overlooks and disregards the positive testimony as to the details of his renting business on direct examination (R. 51-53) and on cross-

examination (R. 58-61, R. 64-65). As shown in Mr. Rubino's testimony summarized in our statement of facts above, he was engaged simultaneously in several businesses including the renting of dwellings. And it is well established in the cases pertaining to the application of the definitions in sections 117(a)(1) and 117(j)(1) that a taxpayer may be considered as being in two or more businesses at the same time.

George S. Jephson, 37 B. T. A. 1117 (1938);

N. Stuart Campbell et al, 5 T. C. 272 (1945);

Leland Hazard, 7 T. C. 732 (1946); and

William H. Jamison, 8 T. C. 173 (1947).

Another circumstance cited by as "proof" of the petitioners' intention to hold the rented properties "primarily for sale" is the practice of renting without leases on a month to month basis. Here again there is a resort to an assumption that the reason for this was that Mr. Rubino "wished to keep his property easily available for sale". It is suggested that he might with equal reason have assumed that the practice was due to the fact that the terms of renting were so governed by the conditions of his application for priorities and the regulations of the National Housing Agency as to make leases superfluous or to the disinclination of the war workers to whom he was obliged to rent the houses to make leases because of

the temporary nature of their war work employment in Stockton. None of the assumptions either made or not made by Judge Hill in any way weakens the effect of the fact that in every case the dwellings sold were rented at the time of their sale either to the tenant or to others.

As illustrating the possibility of personal prejudice of Judge Hill against the petitioner husband attention is called to his putting an answer which that petitioner had not made into his mouth in the colloquy on pages 51 and 52 of the Record where he stated that Mr. Rubino had said "Not to my knowledge" in response to the question "You still have houses to rent?"; and to his sharp reproof to Mr. Rubino (R. 69).

> All we want is a frank statement of what your business is. We don't want too much of this "don't know" stuff. Apparently you are a pretty good businessman.

It is submitted on a reading of the petitioner husband's whole testimony that his inability to testify to the details of his business and transactions was no different or more pronounced in his answers on cross-examination than they had been on his direct examination. Throughout the testimony there was evidenced a habit and disposition on Mr. Rubino's part to leave the details of transactions to his bookkeeper, his accountants, and his rental agents.

His own counsel had just about as much difficulty in getting concise and detailed responses from him as did the Court and the respondent's counsel.

In conclusion it is submitted that there is nothing in Judge Hill's opinion in explanation of his finding of ultimate fact on the main issue in this case which explains away the effect of the respondent's stipulation that the houses in question were subject to a deduction for depreciation because they were used in the petitioners' business of renting dwellings to preclude any finding or conclusion that such dwellings were held "for sale to customers in the ordinary course of (their) business".

CONCLUSION

In view of our showing above (1) that the provisions of section 117(j) were intended as a relief provision to be construed liberally in favor of the taxpayer, (2) that the decision of The Tax Court against the petitioners was inconsistent with a consistent line of cases of that Court on sales of rent properties, and (3) that Judge Hill's finding of ultimate fact complained of was precluded and inhibited by the respondent's stipulation of a depreciation al-

lowance on the very houses the sale of which is the subject of controversy, it is prayed that this Court of Appeals reverse the decision of The Tax Court on this issue.

Respectfully,

Wareham C. Seaman
Attorney for the Petitioners